

SUMMARY OF O.M.B. CIRCULAR A-122

Cost Principles for Non-Profit Organizations

A. Basic Considerations - To be allowable, costs must meet the following general criteria:

1. Costs must be reasonable:
 - a. Recognized as ordinary and necessary.
 - b. Arms length transactions.
 - c. Individuals concerned acted with prudence.
 - d. Not deviating from established practices of the organization.
2. Costs must be allocated to the grant, project, etc. in accordance with benefits received:
 - a. Incurred specifically for the award.
 - b. Benefits both award and other work and can be reasonably distributed in proportion to benefits received.
 - c. Necessary to overall operation - if no direct relationship to award can be shown.

B. Direct Costs

1. Can be identified specifically with a particular grant, award, project, etc.
2. Direct costs of minor amounts may be treated as indirect.
3. Unallowable costs may be treated as direct costs for computation of overhead rates.

C. Indirect Costs

Costs that have been incurred for common objectives but cannot be readily identified with a particular grant, award project, etc. *Only applicable with a HUD certified cost allocation plan.*

D. Allocation of Indirect Costs

1. Simplified Method
 - a. Used when major functions benefit from indirect costs to approximately the same degree.
 - b. Distribution base may be total direct costs, direct salaries or other equitable distribution base.
2. Multiple allocation base method:
 - a. Used when major functions benefit in varying degrees from indirect costs.
 - b. Costs separated into distinct groupings. Each grouping then allocated to benefiting functions by means of base which best measures relative results.

E. Selected Items of Cost

1. Advertising - only advertising costs allowable are those associated with:
 - a. Recruitment of personnel.
 - b. Procurement of goods.
 - c. Disposal of surplus materials.
2. Alcoholic Beverages, unallowable.
3. Bad debts - unallowable.
4. Bonding costs - allowable.
5. Communication costs - allowable.
6. Compensation for personal services:

- a. Includes salaries, wages, incentive awards, fringe benefits, pension plan costs, location allowances and cost of, living differentials.
- b. Allowable provided they are reasonable.
- c. May be direct or indirect. Fringe benefits in the form of vacation, sick pay, holidays, and authorized absences are allowable provided they are absorbed by all organization activities in proportion to relative time or effort devoted to each.
- d. Fringe benefits in the form of social security, employee insurance, workmen's compensation, pension plans, etc. Are allowable provided they are distributed in accordance with salaries and wages chargeable to particular awards and activities.
- e. Charges to award for salaries and wages must be supported by documented, approved payroll records:
 - i. Distribution must be supported by personnel activity reports (time sheets).
 - ii. Time sheets must be maintained by all personnel whose compensation in whole, or in part, is charged to government awards.
 - iii. Time sheets must reflect after-the-fact determination of actual activity of each employee.
 - iv. Each time sheet must account for employee's total time.
 - v. Time sheets must indicate total number of hours worked each day.
 - vi. Time sheets must be signed by employee and approved by supervisor.
 - vii. Time sheets must be prepared at least monthly and coincide with one or more payrolls.
6. Contingency reserves - unallowable
7. Contributions - unallowable
8. Depreciation - allowable
9. Donated services:
 - a. Not reimbursable.
 - b. May be used in overhead computations in allocating indirect costs.
10. Employee moral, health, and welfare costs - allowable as indirect cost.
11. Entertainment costs - unallowable.
12. Equipment and other capital expenditures:
 - a. Equipment - Personal property with a useful life of more than 1 year costing \$5000 or more per unit.
 - i. Special purpose equipment - usable only for research, medical, scientific or technical activities - allowable as direct cost with prior approval of items costing over \$5,000.
 - ii. General purpose equipment - usable for other purposes
 - b. Unallowable as direct costs.
 - c. Depreciation allowable as indirect costs.
 - d. Land, buildings or improvements.
 - i. Unallowable as direct costs.
 - ii. Depreciation allowable as indirect costs.
13. Fines and penalties - unallowable.
14. Idle facilities and idle capacity - unallowable.
15. Insurance and indemnification - allowable.
16. Interest, fund raising, and investment management costs - unallowable.
17. Labor relations costs - allowable
18. Losses on other awards - unallowable
19. Maintenance and repair costs - allowable
20. Materials and supplies - allowable

21. Meetings, conferences - allowable provided they do not involve entertainment costs
22. Membership, subscriptions and professional activity costs- allowable
23. Organization costs (incorporation fees, attorneys, accountants etc. in connection with establishment or reorganization of organization) – allowable
24. Overtime, premium pay - allowable as direct costs with prior approval.
25. Page charges in professional journals - (e-mail publications) - allowable
26. Participant support costs - allowable as direct costs with prior approval
27. Patent costs - allowable only if required by award.
28. Pre-award costs - allowable only with written approval.
29. Professional Service costs - allowable when reasonable in relation to services and not contingent upon recovery from government. In determining allowability, certain factors are relevant:
 - a. Nature and scope of service in relation to service required.
 - b. Necessity of contracting for service vs. Organization's own capability.
 - c. Past patterns of costs.
 - d. Impact of government awards.
 - e. If proportion of government work to total organization work, justify incurring cost.
 - f. Can service be performed more economically by hiring employee.
 - g. Qualifications of individual performing service.
 - h. Adequacy of contractual agreement.
 - i. Retainer fees must be supported by evidence of services available.
31. Profits and losses on sale or retirement of depreciable property:
 - a. Allowable - charge or credit must be included in cost grouping where depreciation was applicable.
32. Public information service costs - (pamphlets, new releases and other forms of disseminating information):
 - a. Allowable as direct costs with prior approval.
 - b. Allowable as indirect costs.
33. Publication and printing costs:
 - a. Allowable as direct costs with prior approval.
 - b. Allowable as indirect costs.
34. Rearrangement and alteration costs - allowable with prior approval.
35. Reconversion costs - (restoration or rehabilitation cost) - allowable with prior approval.
36. Recruiting costs - allowable.
37. Relocation costs - (employee relocation) allowable within certain limitations.
38. Rental costs - allowable within certain limitations.
39. Royalties and other costs for user of patents and copyrights - allowable.
40. Severance Pay - allowable to the extent required by:
 - a. Law
 - b. Employer-employee agreement
 - c. Established policy
 - d. Circumstances of particular employment
41. Specialized service facilities - allowable within certain limitations.
42. Taxes - allowable unless exemptions from taxes are available.
43. Termination costs - (costs in connection with termination of award):
 - a. For common items reasonably usable on organization's other work - allowable.
 - b. Cost continuing after termination - allowable only if cannot be discontinued despite all reasonable efforts.
 - c. Loss of value of special tooling etc. - allowable.

- d. Rental costs - (unexpired leases) - allowable
- e. Settlement expenses - generally allowable
- 44. Training and education costs - allowable
- 45. Transportation costs (related to goods purchases) - allowable
- 46. Travel costs:
 - a. Airline travel allowable except first-class.
 - b. Foreign travel allowable only with prior approval. Each separate trip must be approved.

A-133 Audit Information

The focus of an audit conducted in accordance with OMB A-133 is on the financial statements of the audited organization, as well as the internal controls over, and compliance with applicable laws, regulations and provisions of awards. Many of the compliance requirements associated with an A-133 audit are based on federal laws or on other OMB circulars covering accounting and administrative matters, as adopted by each federal agency.

The type/level of audit required by the OMB circulars is based on the amount of federal financial assistance received by an organization in any given year. **Grantees and subrecipients that expend \$500,000 or more in a year in federal awards must have a single or program audit conducted for that year. This is also referred to as an A-133 Audit.**

Contents of the Reporting Package:

Auditees that have a single audit performed in accordance with Office of Management and Budget Circular A-133 must submit a complete reporting package to the Federal Audit Clearinghouse (and certain pass-through entities) as evidence that the audit was completed. The auditee and auditor share responsibility for preparing the components of the single audit reporting package which must contain:

Financial Statements

Balance Sheet (Reports the financial position at the end of the period)

Components of the Balance Sheet:

- **Assets:** Represents future economic benefits
- **Liabilities:** Represents future economic sacrifices
- **Statement of Cash Flows:** Reports cash inflows and outflows during the period.

Statement of Income

Components of the Income Statement

- Revenues
- Expenses
- Net Income = Revenues – Expenses

Statement of Cash Flow

Components of the Statement of Cash Flows

- Cash flows from Operating Activities
- Cash flows from Investing Activities
- Cash flows from Financing Activities
- Statement of Retained Earnings

If the change in the owner's equity account consists only of the net profit or loss of the project during the year, the change may be noted on the Balance Sheet in lieu of including a separate Statement of Changes in Owner's Equity. If, however, the owner has made contributions or taken distributions during the year covered by the statement, a separate statement of Changes in Owner's Equity should be included with the financial statements.

Basic financial statements have notes, which contain explanatory information relative to the organization and policy changes affecting the preparation of financial statements and account balances, as well as significant accounting policies that have been followed in the preparation of the financial statements by the accountant.

Schedule of Expenditures of Federal Awards

The schedule of Expenditures of federal awards must list individual federal programs by federal agency and the federal programs included in any program cluster. If the auditee receives federal awards as a subrecipient, it also must include in the schedule:

- the name of the pass-through entity
- the identifying number assigned by the pass-through entity
- the total federal awards expended for each individual federal program
- the Catalog of Federal Domestic Assistance (CFDA) number

Summary Schedule of Prior Audit Findings

The auditee is responsible for follow-up and corrective action of all audit findings under Circular A-133. As part of this responsibility, the auditee must prepare a Summary Schedule of Prior Audit Findings. In the summary schedule, the auditee must report:

- the status of audit findings included in the prior year audit's Schedule of Findings and Questioned Costs that relate to federal awards
- the status of audit findings listed in the prior year audits' summary schedule

However, the auditee's schedule does not have to report the status of audit findings listed as corrected, no longer valid or not warranting further action in the prior year's audit summary.

When a finding has been fully corrected, the auditee's Summary Schedule of Prior Audit Findings must list the audit finding and state that corrective action was taken. When an audit finding has not been corrected or has been only partially corrected, the summary schedule must describe the planned corrective action and any partial corrective action taken. If the corrective action taken is significantly different than the corrective action previously stated; the auditee must provide an explanation in the summary schedule.

If an auditee believes that audit findings are no longer valid or do not warrant further action, the auditee must describe the reasons for this position in the summary schedule. A valid reason for believing that an audit finding does not warrant further action, according to the circular, is when all of the following has occurred:

- Two years have passed since the audit report that included the finding was submitted to the Federal Audit Clearinghouse;
- The federal agency or pass-through entity is not currently following up with the auditee on the finding; and
- A management decision (i.e., the evaluation by the federal awarding agency or pass-through entity of the audit finding and the issuance of a written decision as to what corrective action is necessary) was not issued.

Auditees must include the reference numbers assigned by the auditor to each audit finding in the prior year's Schedule of Findings and Questioned Costs. Because the Summary may include audit findings from multiple years, the auditee should be sure to include the fiscal year in which the finding initially occurred as part of the reference number.

The Auditor's Reports

Accountant's Certification

The auditor's report must be manually signed by the firm (or individual practitioner) responsible for the audit; the auditor's name must not be simply printed or typed on the report. The auditor must be an Independent Public Accountant (IPA). An IPA is a Certified Public Accountant (CPA) or a licensed or registered public accountant. The IPA must have no business relationship with the owner or management agent except for the performance of the audit and/or systems work and tax preparation. Opinions or reports signed by the project's bookkeeper, whether a CPA or licensed public accountant, are not acceptable. The whole purpose of the audit is to have an independent, objective third party determine whether the owner's financial statements are accurate; a project's bookkeeper does not qualify as an independent party.

Auditor's report on Financial Statements

Components of the Auditor's Report on Financial Statements

- Title that reads "Independent Auditor's Report."
- Introductory paragraph that identifies the financial statements that were audited.
- Scope Paragraph that describes the nature and objective of an audit.
- Opinion Paragraph on Financial Statements that expresses the auditor's opinion as to whether the statements are fairly presented in all material respects, in conformity with GAAP.
- Opinion Paragraph on Supplemental Data that expresses the auditor's opinion as to whether the supplemental data is fairly presented in relation to the financial statements taken as a whole.

Opinion

Four types of audit opinions may be issued by the auditor:

- Unqualified
- Qualified
- Adverse
- Disclaimer

A qualified, adverse or disclaimer opinion is issued when deficiencies are encountered during the audit that prevent the issuance of the standard (unqualified) opinion. Deviation from this "standard" or "clean" opinion may be acceptable, but must always be explained in the auditor's report. The explanation, if not contained in the scope paragraph may be usually given as a separate explanatory paragraph between the scope and opinion, and should be read carefully for its effect on the reliability of the statements.

Auditor's Report on the Internal Control Structure

As part of the auditor's report, the auditor must prepare a report on the auditee's internal control related to the financial statements and major programs. Internal control is the process an auditee has in place to provide reasonable assurance regarding the achievement of objectives in:

- Effectiveness and efficiency of operations.

- Reliability of financial reporting; and
- Compliance with applicable laws and regulations.

More specifically, the OMB Circular A-133 defines internal control over federal programs as the process an auditee has in place to provide reasonable assurance regarding the achievement of the following objectives for federal programs:

- Transactions are properly recorded and accounted for to permit the preparation of reliable financial statements and federal reports, maintain accountability over assets, and demonstrate compliance with laws, regulations and other compliance requirements;
- Transactions are executed in compliance with laws, regulations and the provisions of contracts or grant agreements that could have a direct and material effect on a federal program and any other laws and regulations identified in the *OMB Circular A-133 Compliance Supplement*; and
- Funds, property and other assets are safeguarded against loss from unauthorized use or disposition.

Auditor's performing a single audit must comply with *Government Auditing Standards* (GAS), which requires the auditor to obtain sufficient understanding of an auditee's internal control over financial reporting to plan the audit and determine the nature, timing and extent of tests to be performed.

The auditor's report on internal control must describe:

- the scope of testing of the auditee's internal control
- the results of the tests
- where applicable, it must also refer to the separate Schedule of Findings and Questioned Costs, which includes a summary of the auditor's results, findings related to the financial statements, which must be reported under FAS, and findings and questioned costs for federal awards.

Auditor's Report on Compliance

In Accordance with GAAS and GAS, the auditor should prepare a written report on the tests of compliance with applicable laws and regulations and the provisions of contracts or grant agreements, noncompliance which could have a material effect on the auditee's financial statements. This report, which may be included in either the report on the financial audit or a separate report, should contain a statement of positive assurance on those items which were tested for compliance and negative assurance on those items not tested. The auditor's test of compliance with applicable laws and regulations should include tests to the extent necessary to comply with GAAS, FAS, and GAAP. Where applicable, the auditor's report on compliance should refer to the Schedule of Findings and Questioned Costs. The independent accountant shall justify any material departure from the language as illustrated in the sample.

Other Reports

As recommended by GAAS, the following reports are prepared by an auditor.

Auditor's Management Letter or Schedule of Findings and Questioned Costs.

When the auditor identifies a finding, the following information should be provided to permit timely and proper corrective action to be taken. The auditor should attempt to identify:

- Condition (the nature of the problem)

- Criteria (what the agency should be doing)
- Effect (what happened as a result of the problem)
- Cause (why the problem exists)

The auditor's Management Letter or Schedule of Findings and Questioned Costs, may be attached to the auditor's report on compliance.

Auditor's Comments on Audit Resolution Matters

This report, which may be included in the Auditor's Management Letter, identifies whether an agency has taken corrective actions on findings from the prior audit report. The auditor should provide the agency name, prior audit report number, a brief description of the finding, and the status of the corrective action on the finding. This report also includes findings contained in program review reports, and state agency reports.

Auditee's Response or Corrective Action Plan

Circular A-133 requires the auditee to prepare a corrective action plan that addresses each audit finding included in the auditor's report. The auditee's corrective action plan must identify:

- a contact person who is responsible for corrective action,
- the corrective action planned and the anticipated completion date.

Also if the auditee does not agree with the audit findings or believes that corrective action is not required, the auditee should include a statement to that effect in the corrective action plan, along with an explanation and specific reasons.

Federal agencies and pass-through entities will review the auditee's corrective action plan to:

- verify the corrective action will be sufficient to prevent the reoccurrence of similar findings
- ensure continued compliance
- recover any questioned costs

If the auditee takes corrective action that is different than what is proposed in the corrective action plan, the auditee must explain the change in the following year's Summary Schedule of Prior Audit Findings.

Status of Corrective Action of Prior Findings

The auditee must comment on all prior findings whether or not corrective action has been completed. The auditee should provide a report on the status of corrective actions taken on prior findings that remain open. An update should be included on dates for completion of major tasks and responsible officials for any actions not completed. In addition, documentation should be submitted for any actions the auditee considers completed.

Sources:

IFP Consulting: Financial Management Workbook, Chapter 3

U.S. Department of Housing and Urban Development: Financial Statements for Non-Profits.

U.S. Department of Housing and Urban Development: Reviewing Annual and Monthly Financial Reports, Directive Number 4370.1

"U.S. GAAP" Website, Generally Accepted Accounting Principles in the United States-Financial Statements

Single Audit Information Service, Volume 1. Thompson Publishing Group, Washington, D. C.